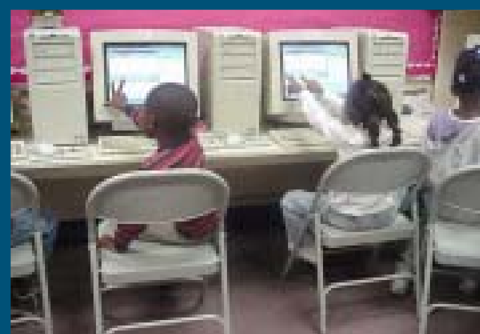
# NO DIVIDENDS:

## HOW TAXPAYERS LOSE UNDER THE BUSH PLAN



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# Executive Summary

On January 7, 2003, President Bush proposed eliminating taxes on corporate dividends. This proposal has been estimated to cost more than $350 billion over the next 10 years.

***No Dividends: How Taxpayers Lose Under the Bush Plan*** examines the impact of the President's proposal on tax-exempt bonds which are used to finance critical public investments such as schools, transit, parks, and clean water projects, and vital community needs such as affordable housing, pollution cleanup, student loans, and hospitals. Specifically, this report looks at the cost of the Bush Administration proposal to taxpayers and at the impact of the plan on the ability of state and local communities to finance important projects at this pivotal moment in our economy.

Municipal bonds (the standard term used for bonds issued by state, regional, and local governments as well as non-profit organizations) hold a unique place in our nation's tax code. The interest on such bonds is exempt from taxation. This special status has been accorded in recognition of the broad public benefit of the projects financed with such bonds.

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The Bush plan would open a whole new arena of tax-free investing by eliminating taxes on corporate dividends – essentially putting investments in corporations on a par with investments in schools and clean water. The proposal would result in bonds competing with corporations for investors seeking tax-free returns, driving up municipal bond interest rates and, thus, increasing costs to taxpayers. Given the size of the stock market (with over 7,000 publicly traded stocks and a market capitalization of approximately $11 trillion) compared with the size of the municipal bond market ($1.7 trillion in outstanding bonds held), the negative impacts of the Bush proposal on municipal bonds are expected to be significant.

Since the release of the President's proposal, there has been a broad consensus among experts that the Bush plan will increase municipal bond interest rates. While varying views as to the extent of impact have been expressed, quantitative projections offered to date have been in the range of 0.25 percent to 0.50 percent in increased interest rates. Utilizing the 0.50 percent projection, this report makes the following findings:

- Across the nation, taxpayers would pay $154.96 billion in increased interest costs over the life of bonds projected to be issued by states and localities over the next 10 years.

- California taxpayers would pay $17.21 billion in increased interest costs over the life of bonds projected to be issued at the state and local level over the next 10 years. The amount of bonds projected to be issued annually is based on the annual average over the last five years.

- The increased interest cost to California taxpayers on approximately $28.45 billion in voter-approved state bonds alone, which have not yet been sold, would reach $3.26 billion over the life of those bonds.

Across the nation, taxpayers would pay $154.96 billion in increased interest costs over the life of bonds projected to be issued by states and localities over the next 10 years.

- Increased interest rates on California state and local bonds will require that a greater portion of annual debt service be dedicated to the payment of interest, thus reducing the capacity of state and local governments to issue bonds for critical public projects. An increased interest rate of 0.50 percent would result in $9.36 billion less capacity for state and local bonds over the next 10 years – which is equivalent to the cost of 985 elementary schools.

The report analyzes the impact of the President's tax proposal on long-term bond issues. Refunding issues were excluded, despite the fact that the proposal would have similar impact on refunding interest rates, because the volume of future refunding issues cannot readily be projected from available data.

The report also analyzes the impacts of the President's tax proposal assuming increased interest rates of 0.25 percent.

Based on the above analyses, the report concludes that the Administration's tax plan will have a detrimental effect on taxpayers in California and across the country and upon the ability of states and local communities to cost-effectively finance the public investments which are essential for economic recovery and progress.

## Introduction

Last week, President Bush proposed eliminating taxes on corporate dividends. The President advanced this proposal as the cornerstone of his economic stimulus package. However, his proposal would have significant negative impacts on taxpayers and on critical public investments – from schools to transportation to parks – by raising the interest cost on tax-free municipal bonds used to finance the state and local infrastructure projects that are essential to the economic well-being of every community in this state and nation.

For decades, municipal bonds – the standard term for bonds issued by state and local governments, joint powers agencies, and other not-for-profit organizations – have held a unique place in our nation's tax code. Federal law provides that interest earned by investors in municipal bonds is exempt from federal income taxes. Most states make similar provisions for municipal bonds issued in their states, exempting them from state income taxes as well.

The purpose of this long-standing special status for municipal bonds is to allow for the low-cost financing of vital capital projects with broad public benefit – projects such as schools, universities, transportation, hospitals, and clean drinking water systems – that ensure the health and safety of our communities as well as the sustainability and competitiveness of our economy and quality of life.

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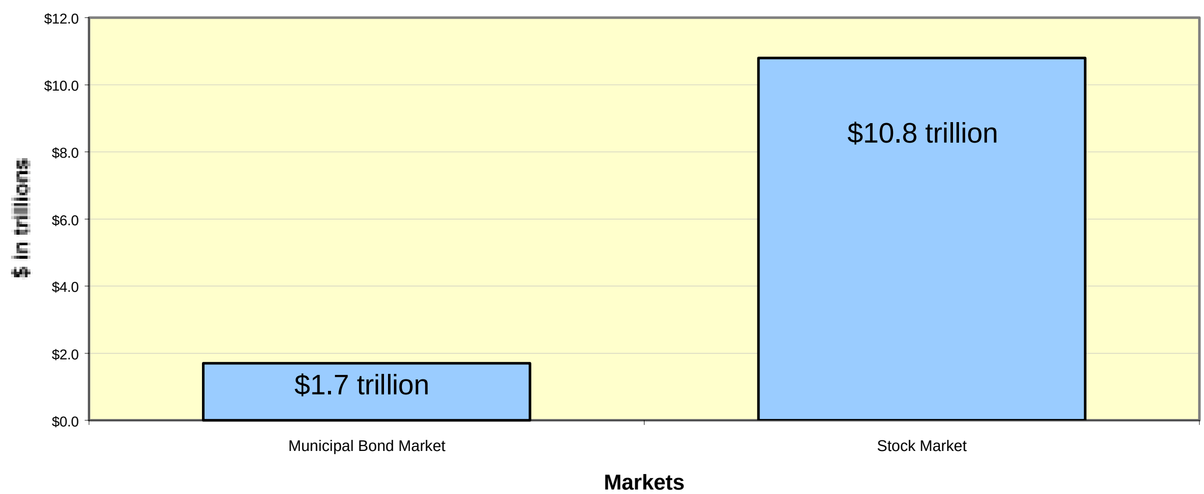
Past administrations of both parties have long recognized tax exemptions as a precious resource to be carefully managed. Indeed, following significant increases in the use of tax-exempt bonds in the early 1980s, the Tax Reform Act of 1986, signed by President Reagan, significantly limited the issuance of tax-exempt bonds for private-sector projects of public benefit, such as affordable housing, pollution control, student loans, and small manufacturing enterprises. The federal government now imposes strict caps on the amount of these bonds and requires each state to carefully evaluate and determine the public benefits of all projects awarded the right to use tax-exempt bonds. In California, demand for these public benefit bonds has consistently exceeded supply. Under these circumstances, many deserving projects that would strengthen California communities do not receive an allocation of tax-exempt financing, forcing them to use more costly taxable financing.

By contrast, the President's across-the-board proposal would provide that investments in publicly-traded corporations would be accorded the same tax-exempt status as investments in the public fabric – such as schools, transportation systems, parks, and hospitals – that have long been acknowledged to be of broad public benefit and essential to our communities, states, and nation. By making corporate dividends tax-free, the President's proposal would provide a whole new marketplace for investors to seek tax-free returns, forcing municipal issuers to compete for limited investor dollars, thus pushing up the interest rates for municipal bonds.

This proposal would undermine the ability of communities to make these long-term infrastructure investments by disadvantaging the financing tools so carefully crafted for these purposes over several decades and under the stewardship of both leading political parties. The proposal would have two related impacts – it would drive up the interest costs paid by taxpayers, and would reduce communities' bonding capacity for these vital public projects.

The scale of the stock market presents a significant potential for affecting the much smaller municipal market. According to the Federal Reserve, the nation-wide municipal bond market is comprised of approximately $1.7 trillion in outstanding bonds, of which only a very small portion is not tax-exempt.[1] That size compares to a projected stock market capitalization of approximately $11 trillion,[2] and over 7,000 publicly-traded companies. Seventy percent of companies in the S & P 500 index currently pay dividends. The same is true for 30 percent of the companies, representing more than 73 percent of the market capitalization, comprising the Wilshire 5000 index, one of the broadest indices for the US stock market.[3] See Figure 1.

**Figure 1**
**Stock Market Dwarfs National Municipal Bond Market**




** The Federal Reserve estimates that about 3 percent of long-term municipal issuance since 1986 has been taxable bonds.*
*** Combined NASDAQ, NYSE, and Amex includes 7,225 companies with a market capitalization of $10.8 trillion as of September 30, 2002. Wilshire 5000 index includes 5,667 companies with a market capitalization of $10.2 trillion as of January 2003.*

This report looks at the nature and magnitude of the risk of the President's proposal to tax-exempt bonds and provides concrete analyses of the potential impact on taxpayers and on communities attempting to finance the public benefit projects that will be needed over the next decade to sustain our state's and nation's economic well-being.

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## Expert Opinions See Negative Impacts

Market experts agree that an across-the-board elimination of federal income taxes on stock dividend payments would create a category of corporate investments in direct competition with municipal bonds, since income from these stock dividends would be treated the same as income from municipal bond interest payments. Upon announcement of the proposal by the President last week, the California State Treasurer's Office conducted a survey of public comments which had been offered by experts on the subject. This report reflects the views we compiled through Monday, January 13, 2003.

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There has been broad consensus that the Bush Administration's proposal would have a negative impact on municipal bonds, even as there are various opinions about the magnitude of the problem. To date, of those commenting publicly, some have given quantitative projections, along with characterizations of the impact ranging from modest to significant. Longer maturities generally were expected to bear a larger burden of the impact. The range of estimated relative increases in municipal bond interest rates noted by these experts was 0.25 percent to 0.50 percent (25 to 50 basis points).

While not every expert went so far as to quantify the potential impacts, they still noted the higher borrowing rates to be faced by municipal borrowers in the face of a new, competing source of tax-free income, and the disproportionate impact municipal bonds would bear in the event of any increased flow to stocks as a result of the President's dividend tax proposal. Of course, it should be pointed out that there are a number of factors that will influence the future interest cost on municipal bonds, including Federal Reserve actions, the level of federal borrowing, and even municipal bonds' underlying benefits, such as diversification and low default rates.

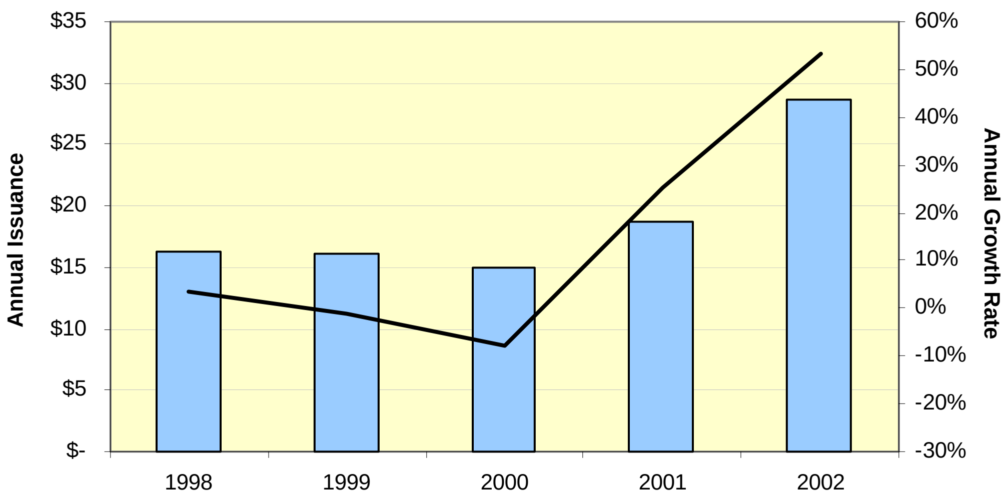
This report uses a range of 0.25 percent to 0.50 percent (25 to 50 basis points) to explore the dollar impacts to taxpayers and communities if these projections are borne out. The report analyzes the impact of the President's tax proposal on long-term bond issues. Refunding issues were excluded, despite the fact that the proposal would have similar impact on refunding interest rates, because the volume of future refunding issues cannot readily be projected from available data.

The report looks first at the impacts on California and then on the nation as whole.

## Impacts on California

Over the past five years, the volume of long-term municipal bonds issued in California reached a cumulative total of $94.74 billion from 1998 through 2002, for an annual average of $18.95 billion (excluding short-term paper and refunding issues).[4] See Figure 2.

**Figure 2**
**Combined California State and Local Bond Issuance 1998-2002**
**($ in billions)**




Sources: The Bond Buyer (Tax-Exempt vs. Taxable Totals) and the California Debt and Investment Advisory Commission (CDIAC) (Refunding vs. New Money Totals) data were used to compute the total Tax-Exempt New Money volume for 1998 – 2001. The data for 2002 was obtained from CDIAC.

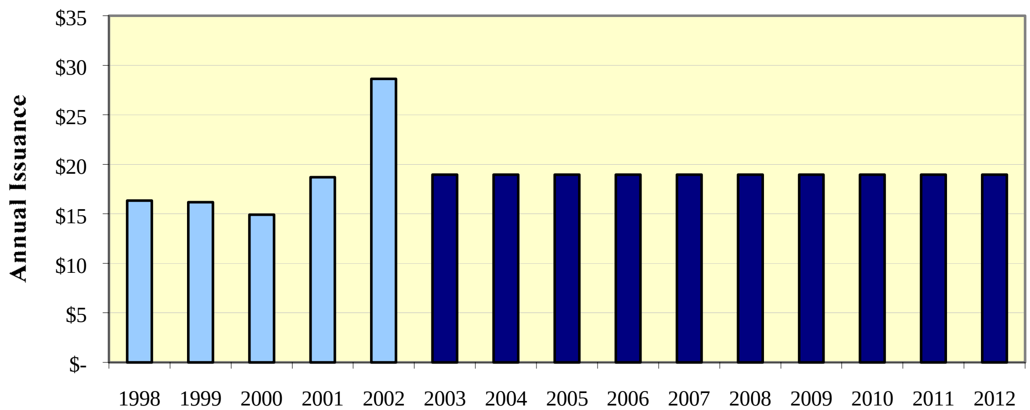
This volume consisted of bonds issued by the State, counties, cities, school districts, special districts, and regional authorities, among others, for a wide variety of public purposes, such as schools, transit systems, parks, and public utility infrastructure. The purposes also included not-for-profit projects, such as health clinics, animal shelters, and museums, as well as the private-sector projects of significant public benefit, such as affordable housing and small manufacturing facilities, which have been approved for use of federally-restricted tax-exempt bonds.

Assuming the average volume of the last five years were to continue, this report projects a combined California state and local bond issuance volume over a future 10-year period, resulting in total volume of $189.48 billion.[5] It should be noted that this conservative assumption of flat

[4] *Sources include The Bond Buyer Yearbook (1998-2002) and the California Debt and Investment Advisory Commission (CDIAC).*
[5] *The compound average annual growth rate between 1998 and 2002 (inclusive) was 15.06 percent. However, as noted above, this report does not apply this growth rate to the 10-year projections. The report assumes 25-year maturities and level annual debt service on the same $18.95 billion in projected annual volume for each of the 10 years.*

issuance levels does not take into account either current infrastructure backlogs or projected population growth in California. See Figure 3.

**Figure 3**
**10-Year Projected California State and Local Bond Issuance**
**($ in billions)**




*Sources: The Bond Buyer and CDIAC data were used to compute the total Tax-Exempt New Money volume for each year shown between 1998-2002 (inclusive). The 10-year projection was done at the average of the prior five years.*

At an average increase in municipal bond interest rates of 0.50 percent (50 basis points), applied across all maturities for simplicity, the total increased interest payments by California taxpayers over the life of the bonds projected to be issued over the next 10 years would equal $17.21 billion. Performing the same analysis using an average increase in interest rates of 0.25 percent (25 basis points) would result in total increased interest payments by California taxpayers over the life of the bonds equal to $8.56 billion. See Figure 4.

**Figure 4**
**California Taxpayers Would Pay Significantly More Interest**
**Under President's Proposal**

| | **0.50 Percent Increase In Municipal Bond Interest Rates** | **0.25 Percent Increase In Municipal Bond Interest Rates** |
|---|---|---|
| **Total Bonds Projected to Be Issued Over 10 Years** | $189,480,989,000 | $189,480,989,000 |
| **Total Increased Interest Costs Over the Life of the Bonds*** | $17,214,499,886 | $8,556,848,756 |

** Assumes 25-year final maturity and level annual debt service.*

Not only are these increased interest costs borne directly by taxpayers, but they also translate directly to less capacity for California state and local bonds, and thus less funding available for vital public infrastructure. At the 0.50 percent (50 basis point) increase in interest rates and the issuance patterns assumed above, California would have $9.36 billion less in capacity for state and local municipal bonds over the same 10-year period. At an average cost per elementary school of approximately $9.5 million,[6] that is equivalent to losing funding for 985 schools at a time when we are struggling to keep pace with current needs, let alone long-term enrollment projections. Likewise, at the 0.25 percent (25 basis point) increase in interest rates, California would have $4.77 billion less in capacity for state and local bonds under the same analysis, equivalent to the cost of 502 elementary schools. See Figure 5.

**Figure 5**
**California and its Communities Would Lose Significant Bonding Capacity Under President's Proposal**

| | **0.50 Percent Increase In Municipal Bond Interest Rates** | **0.25 Percent Increase In Municipal Bond Interest Rates** |
|---|---|---|
| **Increase in Average Annual Interest Costs** | $688,579,995 | $342,273,950 |
| **Lost Bonding Capacity Over 10 Years** | $9,356,909,000 | $4,769,519,000 |
| **Average Cost of 600-Student Elementary School** | $9,500,000 | $9,500,000 |
| **School-Equivalent of Lost Bonding Capacity** | 985 schools | 502 schools |

This report also examined the impact of the President's proposal by looking at the narrower category of $28.45 billion in State of California general obligation bonds already approved by the voters but not yet issued. We used the same range of potential increased interest costs identified previously, that is, 0.50 percent (50 basis points) and 0.25 percent (25 basis points).[7]

The projected 0.50 percent (50 basis point) increase in interest rates would result in total increased interest costs paid by California taxpayers over the life of the bonds equal to $3.26 billion. At a projected 0.25 percent (25 basis point) increase in interest rates the analysis shows total increased interest costs paid by California taxpayers over the life of the bonds equal to $1.62 billion. See Figure 6.

[6] *State of California Department of General Services, Office of Public School Construction, based on 600-student elementary school construction costs.*
[7] *General obligation bonds assumed to have 30-year final maturities, with level annual debt service.*

**Figure 6**
**California Taxpayers Would Pay Significantly More Interest**
**On Voter-Authorized State Bonds**
**Under President's Proposal**

| | **0.50 Percent Increase In Municipal Bond Interest Rates** | **0.25 Percent Increase In Municipal Bond Interest Rates** |
|---|---|---|
| **Total Bonds Authorized but Unissued (as of 1/14/03)** | $28,454,314,000 | $28,454,314,000 |
| **Total Increased Interest Costs over Life of the Bonds*** | $3,255,447,153 | $1,617,700,973 |

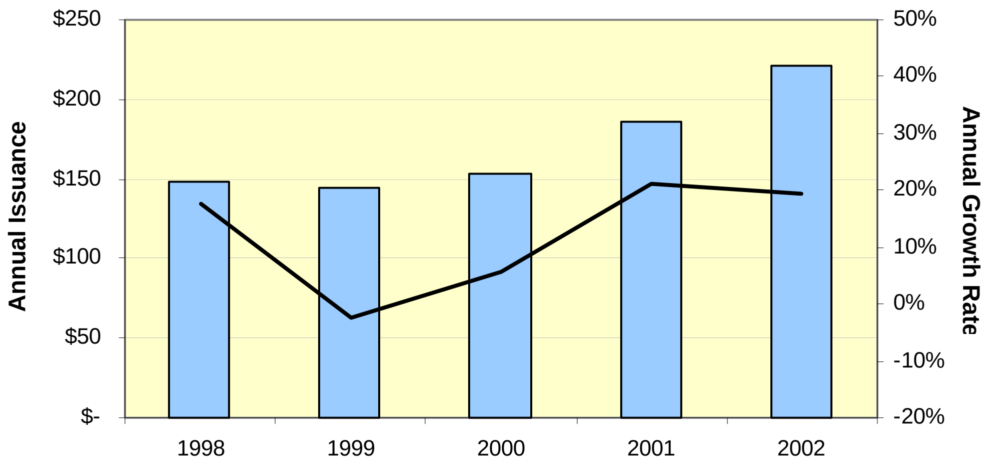
** Assumes 30-year final maturity and level annual debt service.*

Looking again at the impact of the President's proposal in terms of lost bonding capacity for California, at the 0.50 percent (50 basis point) increase in interest rates the State of California would have $1.58 billion less in bonding capacity for general obligation bonds for these critical voter-authorized projects. Likewise, at the 0.25 percent (25 basis point) increase in interest rates the State of California would have $806 million less in bonding capacity under the same analysis.

## National Impacts

Over the past five years, the volume of long-term municipal bonds issued at the state and local level nationwide reached a cumulative total of $852.84 billion from 1998 through 2002, for an annual average of $170.57 billion (excluding short-term paper and refunding issues). See Figure 7.

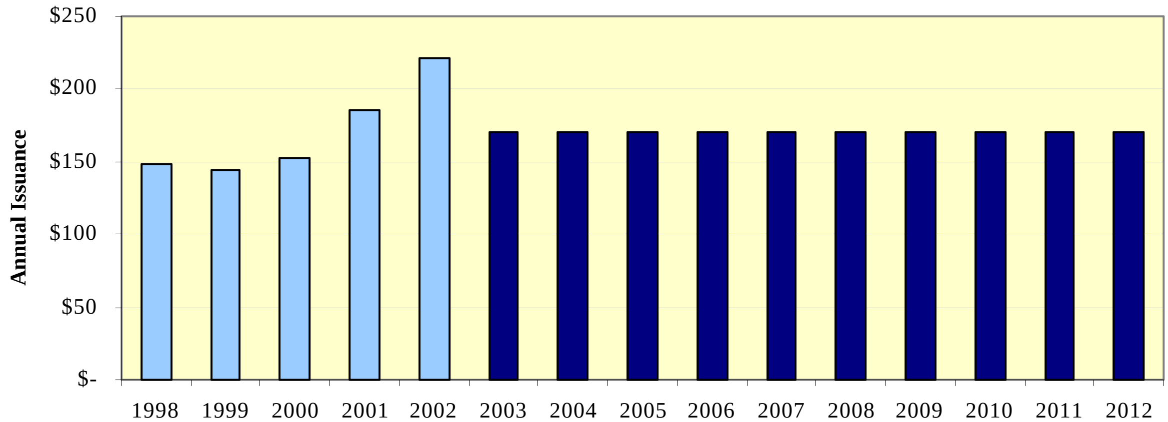
**Figure 7**
**National Tax-Exempt Bond Issuance**
**1998 – 2002**
**($ in billions)**




*Sources: The Bond Buyer data were used for 1998-2001 and Securities Data Corporation data were used for 2002.*

Assuming the average volume of the last five years were to continue, this report projects nationwide state and local bond issuance volume over a future 10-year period, resulting in total volume of $1.71 trillion. See Figure 8.

**Figure 8**
**10-Year Projected National Tax-Exempt Bond Issuance**
**($ in billions)**




*Sources: The Bond Buyer data were used for 1998-2001 and Securities Data Corporation data were used for 2002. The 10-year projection was done at the average of the prior five years.*

At an average increase in municipal bond interest rates of 0.50 percent (50 basis points), applied across all maturities for simplicity, the total increased interest payments by our nation's taxpayers over the life of the state and local bonds projected to be issued nationwide over the next 10 years would equal $154.96 billion. Performing the same analysis, using an average increase in interest rates of 0.25 percent (25 basis points), would result in total increased interest payments by our nation's taxpayers over the life of these bonds equal to $77.03 billion. See Figure 9.

**Figure 9**
**America's Taxpayers Would Pay Significantly More Interest**
**On State and Local Bonds**
**Under President's Proposal**

| | **0.50 Percent Increase In Municipal Bond Interest Rates** | **0.25 Percent Increase In Municipal Bond Interest Rates** |
|---|---|---|
| **Total Bonds Projected to Be Issued Over 10 Years** | $1,705,682,600,000 | $1,705,682,600,000 |
| **Total Increased Interest Costs Over the Life of the Bonds*** | $154,962,635,636 | $77,027,708,702 |

** Assumes 25-year final maturity and level annual debt service.*

These increased interest costs translate directly to less capacity for state and local bonds nationwide, and thus less funding available for our nation's vital public infrastructure. At the 0.50 percent (50 basis point) increase in interest rates and the issuance patterns assumed above, America's communities would have $84.23 billion less in capacity for state and local municipal bonds over the same 10-year period. Likewise, at the 0.25 percent (25 basis point) increase in interest rates, America's communities would have $42.93 billion less in capacity for state and local bonds under the same analysis. See Figure 10.

**Figure 10**
**America's Communities Would Lose Significant Bonding Capacity**
**Under President's Proposal**

| | **0.50 Percent Increase In Municipal Bond Interest Rates** | **0.25 Percent Increase In Municipal Bond Interest Rates** |
|---|---|---|
| **Increase in Average Annual Interest Costs** | $6,198,505,425 | $3,081,108,348 |
| **Lost Bonding Capacity Over 10 Years** | $84,229,630,000 | $42,934,555,000 |

## Conclusion

There is a consensus view that the Bush Administration's dividend tax proposal would have a negative impact on taxpayers and on critical public investments – from schools to transportation to parks. These conclusions are independent from other potential concerns about the wisdom of this dramatic proposed policy shift.

By relying on the various experts who quantified their projections in the days immediately following the President's release of his proposal, this report has brought the true implications of these projections into sharper focus. The report translates the projected negative impacts from the esoteric world of yield spreads to concrete dollar terms that show clearly how California's and this nation's taxpayers and public fabric would be harmed should these projections be borne out.

The report translates the projected negative impacts from the esoteric world of yield spreads to concrete dollar terms that show clearly how California's and this nation's taxpayers and public fabric would be harmed should these projections be borne out. ■

Our analyses show that even modest impacts in percentage terms can translate to significant real dollars over time when applied to the potential volume of municipal bonds projected to be issued over the next 10 years. The President's proposal comes at a time when Americans can ill afford to raise the costs of investing in the public infrastructure needed to sustain our nation's economic progress.